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SUBJECT: Iceland's Financial Crisis: The Russia Angle

Classified by: Ambassador Carol van Voorst for reasons 1.4 (b) and (d).

¶1. (C) The announcement by Iceland's Central Bank on October 7 that Russia would provide a USD 5.4 billion loan created an international stir, unleashing a wave of speculation as to who had approached Russia, why and when the contact was made, and what the Russians could be contemplating as the quid pro quo. The who and when questions seemed to have been put to rest by Prime Minister Geir Haarde's comment last week that he had discussed assistance with the Russians in August "on his own initiative." As for the quid, everything from landing, refueling, maintenance or other rights at the former U.S. base at Keflavik, to advantageous exploration and exploitation rights in potential gas and petroleum fields under Icelandic waters, has been suggested.

¶2. (C) Following the announcement, a team of Central Bank and other financial experts traveled to Moscow October 14-15 for talks. They did not return with a deal, but did hold open the possibility of further talks. Although we have been told there have been telephone and e-mail contacts, there have been no subsequent meetings. In the meantime, Russian government comments to the press have been getting progressively bleaker, hinting at doubts concerning Iceland's creditworthiness. There has also been casual talk that Iceland's failure to gain a UN Security Council seat last month may have lessened Russian interest. International press stories outlining Russia's own financial difficulties appear to have significantly dampened expectations here. As more time passes without a successful deal, Russia's motives have been questioned, including suggestions that Moscow was never serious about the loan and offered it only as a public relations stunt to boost Russia's image and discomfit the West. (If so, this tactic has not worked all that well: Icelandic polls taken in October 2006 and October 2008 show the same 39 percent of the population favorably disposed towards Russia, though the negatives in 2008 are slightly higher.) Although the Icelandic government asserts in public that the deal is still on the table and bilateral discussions will continue, in private, high-ranking sources in the MFA and the Prime Minister's office tell us that the deal is on the back burner and they want it to stay there. Iceland has no interest in a bilateral financial arrangement with Russia except as a last life-saving effort should friends and allies fail to come through with credit. Icelandic leaders hope that any such loan would be included as part of the IMF bail-out, with Russia only one of a consortium of lender countries. If it is a separate bilateral deal, however, the government has also repeatedly assured us and the public that the loan would be a purely financial transaction, with no foreign policy implications. Few we have talked to believe that Russia would actually be so altruistic.

¶3. (C) There has been no lack of theories and entertaining "informed" comment as to why the Russians would be willing to offer financial assistance for the first time to a NATO country. Much of the speculation we have heard features one or all of the following: corrupt Russian oligarchs, Prime Minister Putin, shady bank dealings,

money laundering, and secret accounts in the now-failed Icelandic banks. One well-placed observer points to a purported close friendship between Russian Ambassador Victor Tatarintsev and PM Putin that supposedly inclined the Prime Minister to be generous to Iceland; other commentators suggest secret illicit connections between various oligarchs and the now defunct Icelandic banks or their European branches and subsidiaries. A story that circulated among the international press camped out in Reykjavik two weeks ago claimed that the Russian leadership offered the loan to recover Russian state property that had been illegally put up as collateral for a loan that a company closely tied to Putin had obtained from Iceland's Kaupthing Bank.

¶4. (C) The matter remains a puzzle, and post can't claim to have a firm fix on any part of it. The MFA Permanent Secretary told the Ambassador the MFA had no knowledge of any bilateral loan discussions before the Central Bank announcement. A senior MFA source blamed the whole business on Central Bank shenanigans, asserting that the Prime Minister did not know of the contacts between the central banks until very recently. Yet another senior official told us that the loan offer started off as something quite different: when an Icelandic citizen owner of a small bank in St. Petersburg complained of problems with currency transactions, the Russian Central Bank proposed to the Icelandic Central Bank that the two institutions discuss some sort of cooperation, presumably a currency swap. At some point this summer, the Prime Minister was made aware of and became involved in the budding deal. How the currency swap became a huge loan offer is left unclear. What does seem certain, though, is that the Central Bank's announcement of the loan offer came as a surprise to many, including members of the Prime Minister's office and the Foreign Minister's inner circle.

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¶5. (C) Of all the government representatives who have discussed the loan in public, Central Bank Governor David Oddson has been the most obviously enthusiastic. If the Central Bank announcement was an attempt by this former Prime Minister and champion wheeler-dealer to pressure lagging friends - particularly the U.S. - into quickly offering their own loans, the game has not been successful. Except for Norway, whose Foreign Minister announced a loan today, the Nordics and the rest of the potential lenders continue to mull over a decision.

¶6. (C) There is little public or government support for the loan except as a last-ditch effort to rescue Iceland from financial ruin. Since the closing of the base at Keflavik in late 2006, the Icelanders have kept a wary eye on the increasingly visible Russian military activities in the High North. They don't like the Russian presence in the North Atlantic and don't want to encourage it. This government most particularly doesn't want to be beholden to Moscow. No letter to Russia was included in the flurry of missives sent last week to potential lenders, including the U.S., the European Central Bank, China, Japan, and the Nordics. However, if the Icelanders can't find the USD four million they need to complete the agreement with the IMF from sources they prefer, then sheer necessity will dictate that they take whatever the Russians make available. As to the terms of that loan, stated or implied, the deepening financial crisis and the pending social upheaval here suggests that the Icelandic government will be in no position to be too choosy.

VAN VOORST